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IN THE

Supreme Court of the United States

October Term, 1929

No. 60

CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE,

Petitioner,

vs.

W. L. SLAYTON,

Respondent.

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit

BRIEF FOR RESPONDENT IN OPPOSITION

E. J. MARSHALL, *Toledo, Ohio,*
THOS. O. MARLAR, *Toledo, Ohio,*
Attorneys for Respondent

IN THE

Supreme Court of the United States

October Term, 1929

No. 719

CHARLES H. NAUTS, COLLECTOR OF INTERNAL REVENUE,

Petitioner,

vs.

W. L. SLAYTON,

Respondent.

BRIEF FOR RESPONDENT IN OPPOSITION

JURISDICTION

The decree of the Circuit Court of Appeals affirming the decision of the District Court for the Northern District of Ohio, Western Division, was entered on December 6, 1929 (R. 8-11). Petition for writ of *certiorari* was filed March 6, 1930.

QUESTION PRESENTED

The petition for writ of *certiorari* and brief in support presents only one question (page 5 of Brief of Petitioner), namely:

> "Is it within the constitutional power of Congress to withhold from taxpayers in the computation of taxable net income the right to deduct interest paid on indebtedness incurred to purchase or carry obligations of a municipality, while permitting the deduction of other interest paid."

STATEMENT OF FACTS

During the year 1922 the respondent was engaged in the business of buying, selling, and dealing in bonds. In that year he received as interest from municipal bonds owned by him $65,720.06. In addition he received other income, which, less all deductions allowed by the statute, amounted to $106,704.78. During the year he paid as interest on money borrowed to buy and carry the municipal bonds the sum of $78,153.84. In making his income tax return for the year 1922 he excluded the amount of the interest received by him from the municipal bonds, and included the remainder of his income; but he deducted the interest paid on the money borrowed to buy and carry the municipal bonds (R. 2).

Upon review and audit of this return the Commissioner of Internal Revenue disallowed this deduction, and assessed an additional tax for 1922 of $32,606.49. This additional tax, together with interest amounting to $7,778.04, the respondent paid on demand under protest on August 4, 1927 (R. 2, 3.) He then filed a claim for refund which was rejected (R. 5).

The respondent thereupon filed his petition in the United States District Court for the Northern District of Ohio to recover said sum (R. 1, 2), and the petitioner demurred thereto (R. 6). The District Court overruled the demurrer, and, upon failure of the petitioner to answer, entered judgment for the respondent (R. 7, 8). From this judgment an appeal was prosecuted to the Circuit Court of Appeals for the Sixth Circuit (R. 8-11), which sustained the District Court (R. 16, 19).

STATUTE INVOLVED

The Revenue Act of 1921, c. 136, 42 Stat. 227, 237, 239:

> Sec. 213. That for the purposes of this title * * * the term 'gross income'— * * *.
>
> (b) Does not include the following items, which shall be exempt from taxation under this title:
>
> * * * * *
>
> (4) Interest upon (a) the obligations of a state, territory, or any political subdivision thereof, or of the District of Columbia; * * *.
>
> Sec. 214. (a) That in computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (2) All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from taxation under this title;
>
> * * * * *

ARGUMENT

It is submitted that this case is controlled by the case of *National Life Insurance Company vs. United States*, 277 U. S. 508. In the *National Life Insurance Company* case this court declared unconstitutional Section 245 (a) (2) insofar as it undertook to reduce the four per cent deduction of the mean reserve fund of a life insurance company by the amount of interest received from tax exempt securities. Section 245 (a) (2) related solely to life insurance companies. Section 214 (a) (2), the section now involved, relates to individuals and is a very similar provision enacted for the same purpose as Section 245 (a) (2).

The petitioner states the sole question involved (page 5, Brief) as follows:

> "Is it within the constitutional power of Congress to withhold from taxpayers, in the computation of taxable net income the right to deduct interest paid on indebtedness incurred to purchase or carry obligations of a municipality, while permitting the deduction of other interest?"

Such question is clearly answered by the *National Life Insurance Company* case, *supra*, for in the opinion, page 594, it is clearly stated:

> "Congress had no power to purposely and directly tax state obligations by refusing to their owners deductions allowed to others."

Section 214 (a) (2) clearly denies to owners of state or municipal securities deductions allowed to others. Under Section 214 (a) (2) all owners of industrial bonds were entitled to interest deductions for interest paid for

the purpose of purchasing and carrying the industrial bonds, while owners of state, county, municipal or other non-taxable securities were not allowed a deduction for interest paid to purchase and carry these securities.

The actual figures in this case show that it was a distinct disadvantage under the proposed operation of Section 214 (a) (2) for the respondent to carry non-taxable securities.

This disadvantage and discrimination is shown as follows:

(1) If the respondent had received taxable interest, the net income would be computed:		
Gross income — interest from bonds	$ 65,720.06	
Profit from operation of business	106,704.78	
		$172,424.84
Less interest paid to purchase and carry taxable bonds		78,153.84
Net income		$ 94,271.00
(2) By reason of the disallowance of the item of $78,153.84 paid out as interest to purchase and carry non-taxable bonds, the government computed taxable income as follows:		
Gross income from all sources		$172,424.84
Less non-taxable interest $65,720.06. Deduction for interest paid to purchase and carry non-taxable bonds ($78,153.84) not allowed.		
Total deductions		65,720.06
For net income		106,704.78

The respondent suffered an actual loss of interest as follows:	
Interest paid out to purchase and carry non-taxable bonds	78,153.84
Non-taxable interest received	65,720.06
Loss on interest	$ 12,432.78

The government not only denies to respondent his constitutional rights respecting non-taxable bonds, but for tax purposes it treats an actual loss as a gain. By the operation of Section 214 (a) (2) the respondent has not only been denied his constitutional rights respecting his non-taxable securities, but has been subjected to greater tax burdens by reason of such ownership.

The foregoing falls directly within the rule as stated in the *National Life Insurance Company* case, page 593:

> "Thus, he required petitioner to pay more upon its taxable income than could have been demanded had this been derived solely from taxable securities. If permitted, this would destroy the guaranteed exemption. One may not be subjected to greater burdens upon his taxable property solely because he owns some that is free. No device or form of words can deprive him of the exemption for which he has lawfully contracted."

The Circuit Court of Appeals, after considering Section 245 (a) (2) and Section 214 (a) (2) in connection with the *National Life Insurance Company* case, stated (R. 18):

> "In our judgment the situation created by the two sections with respect to the taxation of tax exempt securities is the same, and the applicable principle identical. To deprive the taxpayer of the right to deduct from gross income interest that he has paid during the taxable year, because

that interest was paid on money borrowed to purchase tax exempt securities is, looking through form to substance, directly to tax the interest of such securities, and so not within the power of Congress to authorize."

CONCLUSION

Because of our firm conviction that the controlling principle in the instant case is identical to the principle of *National Life Insurance Company* case, we respectfully submit that the petition for a writ of *certiorari* should be denied.

E. J. Marshall,
Thos. O. Marlar,
Attorneys for Respondent.